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Guidance on Withholding Taxes Reveals Complexities

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Over the past several years, the taxation of nonresidents who work in New York and the withholding obligations of their employers have become extraordinarily complicated, resulting in much confusion as well as significant administrative burdens.

Under the Tax Law, nonresident individuals are taxable by New York on income from New York sources, including income from real or personal property located in New York, income from businesses conducted in New York, and compensation for work performed in New York.[1] Compensation income can include not only wages but also bonuses, consulting payments, and income from stock options. With respect to nonresident individuals who work both inside and outside New York, the regulations provide for a methodology of allocating the income which is based primarily on the percentage of days worked in New York to days worked everywhere.[2] Under the statute and regulations, there is no minimum amount of time spent by a nonresident individual working in New York that triggers the obligation to pay tax on allocable New York source income.

Nevertheless, in the not too distant past, taxpayers and the Department of Taxation and Finance (the "Department") operated under the equivalent of "don't ask, don't tell" when dealing with individuals who traveled occasionally to New York on business to meet with clients, lenders, or professional advisors. Other states effectively adopted similar policies. As a result, individuals who travel occasionally to other states on business would generally report and pay tax to their home states on all of their compensation, ignoring the fact that some portion of their income was attributable to work they performed in other states that is subject to tax in such states. It was generally accepted that every state had residents who periodically worked in other states. Accordingly, any taxes to be gained by taxing nonresidents who worked in a particular state would be largely offset by the tax credits that would need to be given to residents of such state for taxes paid to other states in which they worked.[3] Moreover, enforcement of the allocation and credit provisions would be expensive to administer both for the nonresident individuals as well as the states' tax departments since it would be necessary to keep track of how many days such persons worked in various states. Thus, while, technically, New York and other states may have had the right to tax nonresidents who periodically work in New York or such other states, states did not generally seek to enforce this right. One notable exception to this policy is that New York and other states have, for many years, taxed nonresident athletes[4] and entertainers who often earn large sums working in the state during only a few days. This narrow exception to the general rule was generally understood to be justified.

However, the prior hands-off approach, while rational on an overall basis, only worked so long as all or substantially all of the states enforced their taxes in a similar manner. Once some states decided it was in their interests to raise additional revenues by taxing nonresidents who work occasionally therein, other states would be forced to do the same. Unfortunately, New York and some other states (most notably New Jersey) have decided to go aggressively after nonresidents. Differences in tax rates and other economic factors were significant in this shift in thinking. Tax officials in New York appear to have concluded (possibly correctly) that, since New York's tax rates are generally higher than those in other states, it would gain more in taxing nonresidents than it would lose by giving tax credits for taxes paid to other states. It also appears that tax officials in New York concluded (also possibly correctly) that due to the location in New York of major commercial and investment banks, hedge funds, and national law firms, high income nonresidents would travel to New York to conduct business more often than New York residents would travel to other states. Finally, due to the improvements in information technology, the administrative costs of enforcing more complicated income allocation formulae have decreased. Thus, New York seems to have determined that the advantages to it of taxing nonresidents outweigh the costs. As a result, the Department has asserted that it will enforce the tax on nonresident individuals and has increased the audit activity of high earning nonresidents.

The major impact of the expanded taxation of nonresidents is on employers. While individual workers themselves may be slightly inconvenienced by their taxation in another state, for the most part such individuals receive a credit against the tax due to their states of residence for the amount of the tax paid to the states where they work. For New York employers, however, the consequences are more

severe since, if an employer fails to withhold the right amount of tax from its employees, it is liable to New York for the shortfall.[5] As a result, it is critical that employers know how much to withhold with respect not only to employees based in New York but also with respect to employees based elsewhere who periodically come to New York on business. To that end, in July the Department issued a Technical Service Bureau Memorandum explaining its current policy.[6]

The Memorandum begins by explaining the basic rules of withholding, noting that every employer with an office in New York or transacting business in the state needs to withhold taxes on wages subject to tax by the state. The Memorandum notes that, with regard to employees who only work partly in New York, employers need to withhold only on the New York portion of the compensation. Thus, for example, if a particular individual works 40 percent of the time in New York (say 2 days per 5-day work week), the employer must withhold on only 40 percent of the compensation paid.

The most important development reflected in the Memorandum is its confirmation of the Department's position that withholding will not be required with respect to employees who are expected to and do, in fact, work 14 days or fewer in New York during a calendar year. To be entitled not to withhold on such employees, all the following conditions must be met:

(i) the employee must be assigned to a primary work location outside of New York State;

(ii) the employer must "reasonably" expect that the employee will work in New York State for 14 days or fewer in the calendar year;

(iii) the employee does not, in fact, work in New York State for more than 14 days during the year; and

(iv) the employee does not fall within one of the categories of employees ineligible for the exception to withholding.

The first requirement, that the employee be assigned to a primary work location outside New York State, means the exception from withholding will not apply to New York based employers that hire employees who work at home. Many people are aware that New York applies the so-called "convenience of the employee" test for telecommuters under which employees of New York firms who work from home are generally treated as having worked in New York on such dates.[7] Thus, for employees who come into New York State to work 1 to 14 days, but who also work at home, withholding will be required on all of the compensation paid to them. Although not clear from the Memorandum, it still appears that if an employee spends no time in New York State at all during the year, none of such employee's compensation is New York source income and, accordingly, withholding would not be required for that reason.[8]

The second and third requirements recognize that it will not be possible at the beginning of the year to know for certain whether an employee will, in fact, work 14 days or fewer in New York State during such year. Thus, the employer needs to make a good faith determination. If it is expected that the employee will work more than 14 days, withholding will be required from day one. If it is reasonable to think that the employee will not work more than 14 days, no withholding will be required, unless the employee, in fact, works more than 14 days, in which event withholding will be required on wages paid after the 14th day. But there is nothing in the Memorandum, in such case, to require the employer to catch up on the withholding for the first 14 days. Similarly, if an employee is reassigned to a New York office, withholding will be required on all wages paid after such reassignment.

The Memorandum goes on to list several notable situations where withholding will still be required even if the employee works 14 days or fewer in New York. Athletes are subject to withholding on the portion of their income allocable to New York regardless of the number of days spent in New York. The Memorandum also requires withholding with respect to other individuals connected to athletic activities, such as coaches, trainers, and referees. Since many of these individuals are likely to have income much smaller than that of the athletes, it seems that the rule will be overly burdensome in at least some cases. Entertainers, as well as other individuals involved in television, radio, theatre, and any other filmed or recorded performance, will also be subject to withholding regardless of the number of days spent in New York. Again the Memorandum makes no distinction between highly compensated individuals and other individuals involved in these productions, thereby subjecting large numbers of people to the administrative cost of compliance with relatively little revenue gains.

Compensation paid to commission salesman will also continue to be subject to withholding under prior rules.

The Memorandum also emphasizes that the exception from withholding does not apply to compensation paid in one year for work that relates to income performed in a prior year, such as deferred compensation and compensation from nonstatutory stock options. Thus, someone who works more than 14 days in a prior year cannot avoid withholding by having all or a portion of his compensation paid in a later year.

While the 14-day rule described in the Memorandum will provide some comfort to some New York employers, as described in this article, there remains questions regarding when and if New York employers will need to withhold, which may require litigation to resolve. Stay tuned.

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1 Tax Law section 601(e).

2 Reg. section 132.18. Special rules apply to commission salespersons whose compensation is dependent upon revenues generated (*see* Reg. section 132.17) and to stock options, stock appreciation rights, and restricted stock (*see* Reg. section 132.24).

3 For New York's rules related to credits for tax paid to another state, see Tax Law section 620 and Reg. section 120.1.

4 *See* Reg. section 132.22.

5 *See* Tax Law section 675 (employer liability extends not just to tax subject to withholding but also to additions to tax, penalties, and interest with respect thereto).

6 *See* TSB-M-12(5)I (July 5, 2012).

7 *See* Reg. section 132.18(a).

8 *See*, e.g., *Matter of Friedman*, Docket No. 818271, NY Div. of Tax Appeals, ALJ (June 27, 2002).

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